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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 153

MEMPHIS TRANSIT COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. 1a-31a) is reported at 297 F. 2d 542.

JURISDICTION

The order and judgment of the Court of Claims were entered on December 6, 1961. (Pet. 1, 8a.) Taxpayer's timely motion for a rehearing was denied on March 7, 1962. (Pet. 2.) The petition for a writ of certiorari was filed on June 2, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether the Court of Claims was correct in finding that shares issued by taxpayer to another corporation whose properties it acquired were not in fact part of the consideration paid for those properties.

2. Whether, in computing excess profits tax credit on the invested capital method under the 1939 Code, accumulated earnings and profits should be reduced by income and excess profits tax liabilities for the preceding year as the liabilities existed at the close of that year (as the court below held), or as ultimately decreased by the allowance of net operating loss and unused excess profits credit carrybacks from subsequent years.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 718 of the Internal Revenue Code of 1939 and Section 35.718-2 of the Treasury Regulations 112 (1939 Code), are set out in the Appendix, *infra,* pp. 10-11.

STATEMENT

Two unrelated issues are presented by this suit for refund of income and excess profits taxes for the years 1943, 1944 and 1947. The first, a question of fact, involves a stock transfer in 1905 which, if considered a part of the consideration paid for certain corporate properties then acquired by taxpayer, increases the basis for computing obsolescence losses upon the subsequent abandonment of those properties and reduces the basis for computing taxpayer's excess profits. The second issue involves the meaning of the term "income and excess profits taxes for the preceding taxable year," as used in the Regulations defining "accumulated earnings and profits" for the purpose of comput-

ing excess profits taxes by the equity invested capital method. The Court of Claims upheld the Commissioner on both questions.

1. Taxpayer, a corporation, is engaged primarily in the operation of a motor bus and trackless trolley system in Memphis, Tennessee. Prior to 1945, taxpayer operated an electric street railway system in Memphis. The latter operation was gradually abandoned between 1945 and 1947. (Pet. 8a, 9a.)

In 1905, the Memphis Street Railway Extension Company received a franchise to operate and maintain a street railway system consisting of extensions of lines operated by taxpayer. The Extension Company never operated a streetcar, but it did construct 14.9 miles of rail in 27 extensions to taxpayer's lines and acquired cars, powerhouse equipment, buildings, fixtures and miscellaneous other items. (Pet. 13a-15a.)

On December 18, 1905, taxpayer entered into an agreement with the Extension Company whereby the latter agreed to sell to taxpayer all of its property in exchange for $700,000 of taxpayer's 5% bonds and 25,000 shares of taxpayer's common stock. The properties transferred were to be free and clear of all indebtedness, except the obligation of the Extension Company to pay $650,000 of its notes held by Isidore Newman & Sons, which it agreed to pay upon receipt of the purchase price from taxpayer. (Pet. 16a-17a.)

Although taxpayer had no preferred stock and only 5,000 shares of common stock before entering into the contract, its shareholders, on December 18, 1905, authorized the Company to issue 25,000 shares of preferred stock to the holders of the old common stock, which was retired, and 25,000 shares of new common

stock to the Extension Company. Immediately prior to the recapitalization 4,989 of taxpayer's 5,000 shares of outstanding common stock were held by Isidore Newman & Sons, who also held 495 of the Extension Company's 500 outstanding shares. (Pet. 16a, 17a.)

The improvement costs of the Extension Company, including the physical properties acquired from it by taxpayer, amounted to $700,000, the same amount as the bonds which it received. It had never established a value for its franchise on its books and there was no evidence that it ever intended to operate, or that it could have operated profitably, except as an adjunct of taxpayer's system. (Pet. 28a, 30a.)

Under these circumstances, taking into account the common ownership of taxpayer and the Extension Company, the Court of Claims concluded that the $700,000 in bonds represented the fair and reasonable net value of all assets acquired by taxpayer, and that no consideration reasonably could be attributed to the 25,000 shares (fair market value $70 per share) issued by taxpayer to the Extension Company. (Pet. 27a-28a, 30a, 31a.) Accordingly, the Court of Claims sustained the determination of the Commissioner of Internal Revenue that the share transfer cannot increase the cost basis of the property acquired by taxpayer from the Extension Company, relevant in computing obsolescence losses upon the abandonment of this property during the period 1945-1947, or the equity invested capital basis upon which taxpayer's excess profits are computed. (Pet. 13a, 26a-27a, 31a.)

2. Taxpayer operated at a loss in the years 1945 and 1946. As a result of carrybacks of net operating losses and unused excess profits credits for those years, its income and excess profits tax liabilities were reduced

for the taxable years 1943 and 1944. (Pet. 26a.) In computing taxpayer's excess profits credit on the equity invested capital basis, accumulated earnings and profits at the beginning of the taxable year must be included. The accumulated earnings and profits must be reduced, however, by the income and excess profits taxes for the preceding year. In making the latter adjustment in computing taxpayer's credits for 1944 and 1945, the Commissioner used the 1943 and 1944 income tax liabilities existing prior to the application of the carryback of net operating losses and unused excess profits credits from 1945 and 1946. (Pet. 26a.) Taxpayer maintained in the Court of Claims that the proper amounts were its taxes after the application of such carrybacks. (Pet. 26a.) This legal issue, essentially a matter of statutory interpretation, was decided adversely to the taxpayer; the Court of Claims sustained the method of computation used by the Commissioner. (Pet. 6a-8a.)

ARGUMENT

The decision below is correct. There is no conflict, nor any other reason to grant further review.

1. Whether or not the 25,000 shares of stock issued by taxpayer constituted part of the consideration for property which it acquired from the Extension Company is, ultimately, a question of fact. It remains a question of fact, even though it may be necessary for the lower court to draw inferences from stipulated basic facts. *United States* v. *Gypsum Co.*, 333 U.S. 364 394.

The Court of Claims, after careful consideration of the whole record, found, on substantial evidence, that the property acquired by taxpayer did not exceed in

cost the value of the bonds issued with the stock, that the franchise of the Extension Company had no determinable value, and that the shareholders of both corporations were practically identical. On the basis of those findings, it reasonably concluded that no consideration could be attributed to the issuance of taxpayer's 25,000 shares to the Extension Company. Taxpayer assails this finding solely on the ground that it is contrary to the stipulated basic facts. (Pet. 10-13.)

The argument is that, since it was both stipulated and found that the Extension Company offered to convey its property to taxpayer at an agreed purchase price of 25,000 shares of stock and $700,000 in bonds and that the agreement was carried out according to its terms (Pet. 16a-17a, 7b-8b), the Court of Claims was precluded from inquiring further whether the stock was in fact a part of the consideration paid by taxpayer. (Pet. 10-13.) But the parties stipulated no more than (1) the terms of the offer, (2) that the property was in fact received by taxpayer, and (3) that both the stock and the bonds were in fact received by the Extension Company. It cannot be assumed—and the Court of Claims did not so assume—that the government, intentionally or through inadvertence, stipulated away the principal factual issue in the case.

The fact of the matter is that the Court of Claims applied the familiar rule that the substance and not the form of a transaction controls for income tax purposes. As it said, "this court will not permit the corporate image to serve as blinders when it seeks to answer the question as to what actually occurred here, but will look at the facts in each situation." (Pet. 4a.) In this it was clearly correct.

2. The second issue raised by taxpayer involves the computation of its excess profits credit by the equity invested capital method. Under Section 718(a)(4) of the 1939 Code (Appendix, *infra*, pp. 10-11), accumulated earnings and profits at the beginning of the taxable year are included in equity invested capital. Section 35.718-2 of Treasury Regulations 112 (Appendix, *infra*, p. 11) provides that accumulated earnings and profits should be reduced by the amount of income and excess profits taxes for the preceding taxable year. Rev. Rul. 55-28, 1955-1 Cum. Bull. 359, requires that taxes be computed for this purpose without the benefit of any net operating loss or unused excess profits credit carry-back.

Taxpayer challenges the Revenue Ruling—which was upheld by the Court of Claims—contending that the taxes used in computing accumulated earnings and profits should be reduced by carrybacks from subsequent years. The practical result of the adjustment advocated by taxpayer would be that a carryback from 1945 to the year 1943 not only would produce a tax reduction in 1943 but would also reduce its taxes for 1944.[1]

As the Court of Claims pointed out, the method of computation urged by taxpayer does not conform to the normal principles of tax reporting on the accrual method and is contrary to the rationale of *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237, in which this Court held that carrybacks do not operate retroactively to alter

[1] This double benefit or windfall would result from reducing 1943 taxes, thereby increasing accumulated earnings and profits on hand at the beginning of 1944, which, in turn, would increase the excess profits credit for 1944, and, ultimately, reduce the excess profits tax for 1944.

taxes accrued in prior years. (Pet. 8a.) Taxpayer argues, however, that an adjustment to accumulated earnings and profits is necessary in order to reflect its "true financial status" as of the end of the year. (Pet. 14.) Thus, taxpayer maintains that its "true financial status" as of the end of 1943, for instance, cannot be determined without an adjustment of tax liability based upon a carryback from 1945, despite the fact that the carryback depends upon business losses in 1945. This novel proposition, dubious on its face, finds no support in the jurisprudence or the legislative history of the excess profits statutes.

Taxpayer mistakenly asserts a conflict "in principle" (Pet. 14-16) between the instant decision and *Drybrough* v. *Commissioner*, 238 F. 2d 735 (C.A. 6), and *Pacific Affiliate* v. *Commissioner*, 224 F. 2d 578 (C.A. 9). Apart from the fact that *Drybrough* did not involve the computation of an excess profits credit, both of the latter cases stand only for the proposition that adjustments should be made to accumulated earnings and profits irrespective of the fact that the final determination of the tax liabilities may not be made until a later year. The obviously crucial distinction which taxpayer overlooks is that the liabilities in *Drybrough* and *Pacific Affiliate* were based upon events of the taxable year, and it was only the final determination of such liabilities which was deferred, whereas in the case at bar the theory advocated by taxpayer would require the liabilities to be based upon business conditions and other events in subsequent years.

Finally, the adjustment urged by taxpayer is inconsistent with the legislative purpose underlying the computation of excess profits credits on the equity invested capital basis. That purpose was to provide a measure

by which the amount of excessive profits might be judged. *West Construction Co.* v. *Commissioner*, 7 T.C. 974, 978. A credit based upon capital allows a fair return on the investment which is actually available for use in a taxpayer's business during that taxable year. If a component of that capital, *e.g.*, accumulated earnings and profits, is increased as a result of events in subsequent tax years, the resulting computation of capital for the taxable year is to that extent fictitious.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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JULY, 1962

APPENDIX

Internal Revenue Code of 1939:

SEC. 718 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(l) for determining earnings and profits;

* * *

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year; * * *

* * *

(26 U.S.C. 1952 ed., Sec. 718.)

Treasury Regulations 112 (1939 Code):

SEC. 35.718-2. Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.—(a) *In General.*—

The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. As to determination of additional amount to be included in daily equity invested capital on account of new capital, see section 35.718-4. In computing accumulated earnings and profits as of the beginning of the taxable year, a taxpayer keeping its books and making its income tax returns on the accrual basis shall subtract the income and excess profits taxes for the preceding taxable year. If there is a deficit in the accumulated earnings and profits as of the beginning of the taxable year, such deficit shall not be taken into account in determining invested capital, and in such cases, the earnings and profits as of the beginning of the taxable year shall be considered as zero, but subsequent earnings and profits shall be applied against such deficit. Unrealized appreciation in value of property is not a factor in determining earnings and profits.

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